United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

74-1244

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

ANTOINETTE M. BRAGALINI, ARNOLD DAMSKY, WILLIAM WEINSTOCK, CARL ROGERS and ROSE ROGERS, H. L. FEDERMAN & CO., INC., SUZANNE MASTERS, STEPHEN MASTERS and NORMAN KEMPER, individually and as Stockholders of MASTERS, INC., suing in behalf of themselves and for the benefit of said corporation and for the class of all other stockholders of said corporation similarly situated,

Plaintiffs-Appellants,

-against-

LOUIS BIBLOWITZ, MAX BIBLOWIT, JOSHUA BIBLOWITZ, RALPH J. WEINER, JOEL BIBLOWITZ, ARNOLD GINSBURG, HERBERT ABRAMSON, HARRY GRUNTHER, HARRY L. LEWIS, PINCUS PETERSEIL and MASTERS, INC.,

Defendants-Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF PLAINTIFFS-APPELLANTS

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BRIEF OF PLAINTIFFS-APPELLANTS

Preliminary Statement

Appeal from decision of Hon. Constance Baker Motley, District Judge; decision not reported. The District Court's "Opinion, Findings of Fact, Conclusions of Law" is reproduced in Appendix - Volume I, 11A et seq.

The Issues

1. Whether the proxy statement contained material misstatements and omissions in violation of Securities and Exchange Commission Rule 10b-5.

2. Whether the terms of the merger, which was the subject of the proxy statement, gave unfair advantage to the controlling stockholders, in breach of their fiduciary obligation to the controlled corporation and its minority stockholders.

Statement of the Case

This is a derivative action in behalf of Masters, Inc. and a class action in behalf of its minority stockholders. Masters was controlled and dominated by the defendant Biblowitz brothers who were the sole owners of Lady Rose Stores, Inc. They put the merger of Lady Rose into Masters to a vote of the Masters stockholders in a proxy statement which

contained material misstatements and omissions and effected that merger on terms which advantaged them at the expense of Masters and its minority stockholders. Federal question and pendent jurisdiction were conceded.

After trial on the merits without a jury, the District Court found neither misleading nor overreaching and entered final judgment for the individual defendants. This appeal followed. We submit that the decision below is clearly erroneous in fact and law.

Facts

It was stipulated that the Biblowitzes controlled Masters before and at the time of the merger with Lady Rose, which was wholly-owned by the Biblowitzes. The terms of the merger were approved by the Board of Masters at a board meeting on November 7, 1966 (after first considering the plan at a meeting on October 31, 1966). A proxy statement together with a notice of special meeting of stockholders dated December 22, 1966 was distributed through the mails by Masters. On January 25, 1967, the day before the shareholders voted, the Internal Revenue Service issued an oral ruling that the tax loss carryforward of Masters would be available as an offset against future profits of the surviving corporation; that was followdd by a ruling in writing.

The plan of merger of Lady Rose into Masters was adopted by the stockholders of Masters on January 26, 1967;

all the plaintiffs, representing 60,105 shares of Masters stock, voted against the merger and under the plan the Biblowitzes through Lady Rose were to receive the equivalent of 3,500,000 shares (represented by 1,750,000 common shares and 1,750 non-voting preferred stock convertible on February 1, 1973 into 1,750,000 common shares) which gave the Biblowitzes 90% of the surviving corporation and Masters stockholders approximately 10% (391,102 shares) of the surviving corporation. That ratio of exchange was based on the prices fixed by Lou Biblowitz, $777,000 for Masters and $6,000,000 for Lady Rose.

A. Material Misrepresentations And Omissions In The Masters Proxy Statement.

1. The Biblowitzes' Control of Masters. The proxy statement disclosed that the Biblowitz brothers were 3 of 9 voting trustees under a trust agreement which held a majority of the Masters stock (PX 2, Ex. D thereto, pp. 2-4; 87A). It did not disclose, however, that the Biblowitz brothers, apparently only one-third, in fact controlled the voting trust or in any way disclose the fact (so stipulated, 139A) that the Biblowitzes controlled Masters prior to and at the time of the merger in 1967.*

* The above omission of a statement of control by the Biblowitzes in the 1966 proxy statement should be compared with the following statement of Biblowitz control in the 1969 prospectus of the post-merger Masters, which clearly set forth the true control relationship of the Biblowitz family to Masters and dramatically demonstrates what the (footnote continued on next page)

2. <u>Louis Biblowitz Fixed the Values of Masters for the Merger and What It Was To Get In the Merger.</u> (TR 1400) The proxy statement nowhere disclosed this.

3. <u>The Illusory "Negotiation"</u>. The proxy statement stated (81A):

> "The terms of the merger were arrived at as a result of negotiation between the respective managements of Masters and Lady Rose ..."

There was not in fact and could not be any "negotiation" in any meaningful sense of the word, for as the District Court acknowledged (24A):

> "Obviously, negotiations between the managements of the two companies would be virtually meaningless since the Biblowitzes controlled both managements."

4. <u>The Operating Losses of Masters Due To the Discontinued Florida Operations.</u> The Masters proxy statement reported that Masters had a net <u>loss</u> of $260,000 (97A) for the 12 months ended April 30, 1966. It failed to disclose

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(footnote continued from preceding page)
1966 Masters proxy should have stated (146A):

> "... the Company [Masters] is now controlled by members of the Biblowitz family who were formerly the principal shareholders and officers of Lady Rose and who assumed control of the Company in 1963. The Biblowitz family controlled both the Company and Lady Rose at the time of the merger in 1967 ..."

that all but $3,000 of that amount, to wit, $257,000, was due to the discontinued Florida division of Masters (143A).

The Masters proxy statement showed a net loss from Masters' operations for the nine month fiscal year ended January 29, 1966 of $71,713.00 (97A) and it failed to disclose that a loss of $159,000 was incurred in the discontinued Florida division and that the metropolitan area stores of Masters (which were retained) recorded a profit of $87,000 for that period (143A).

The Masters proxy statement disclosed a net loss of $45,424 (97A) for the three months ended July 30, 1966 but failed to disclose that the loss for the discontinued Florida stores of Masters for that period was $114,000 and that the metropolitan area stores of Masters for that same period had a profit of $73,000 (143A).

The Masters proxy statement showed by adding the net losses for the three months ended April 30, 1966 with the three months ended July 30, 1966 that there was a net loss incurred for the six months ended July 30, 1966 of $233,000 (97A) but failed to disclose that $212,000 of the net loss was due to the discontinued Florida division (143A).

It is noteworthy that post-merger Masters in its 1969 public offering prospectus, when it was to the issuer's advantage to do so, and when the same accounting firm made the

presentation, showed the operating loss from the discontinued Florida division of Masters separately for the fiscal years ending May 1, 1965, April 30, 1966 and January 28, 1967 in the amounts of ($9,000), ($257,000), and ($212,000), respectively (147A).

5. Lady Rose's Income From Concessions In Masters Stores. The proxy statement, in giving the Lady Rose income, failed to disclose that in the latest audited fiscal year, ending February 28, 1966, Lady Rose derived 14.2% of its net income from its concessions in Masters' discontinued Florida operations or $64,000 out of $452,000; that in addition, Lady Rose in that year derived an additional 17.5% or $79,000 of its net income from Masters metropolitan stores (144A) for a total of 31.7% of its net income from Masters and failed to disclose comparable statistics for the prior years (144A).

The proxy did not disclose that for the fiscal year 1963, $86,000* of Lady Rose's net income of $229,000 or 37.6% was derived from concessions in the Masters stores; for fiscal 1964, $68,000 out of $205,000 of Lady Rose's net income or 33.2% was derived from concessions in the Masters' stores; for fiscal 1965, $95,000 out of $301,000 of Lady Rose's net income or 31.6% was derived from concessions in the Masters'

* The breakdown of net income derived from the Florida and metropolitan stores of Masters was stipulated by the parties and that breakdown should have been disclosed (144A, 140A-141A).

stores and for the six months ended August 31, 1966 (unaudited), $93,000 out of Lady Rose's net income of $331,000 or 28.1% was derived from concessions in the Masters stores (Stipulated Fact 144A, 140A-142A, ¶s 21, 23, 25). Therefore the net income of Lady Rose, without income from its Masters concessions, was:

6 months 8/30/66 (Unaudited)	Year to 2/28/66	Year to 2/28/65	Year to 2/29/64	Year to 2/28/63	(Qualified audit)
$238,000	$309,000	$206,000	$137,000	$143,000	

Thus, Lady Rose, without its concessions in Masters, would be significantly less profitable. The Florida concessions ended with the sale of the Florida operations, and the concessions in the metropolitan stores were terminable by Masters on short notice, in any bona fide sale of its assets (PX 148, pp. 9-10, ¶18(k)). Only the Biblowitzs and Kalish Rubinroit & Company were aware of the profits Lady Rose realized in the Masters metropolitan and Florida stores and they failed to disclose that information to the directors and stockholders of Masters (see 73A-77A and 105A-111A).

The proxy did not disclose that one of the principal reasons for the merger was that it "will guarantee the continuance of [Lady Rose's] businesses in the Masters stores." (125A, 3rd ¶ and 123A, 2nd ¶).

6. <u>Bases For Terms of Merger And the Unique Benefits Lady Rose Was To Obtain Incident To the Merger.</u> The proxy statement failed to disclose fundamental facts that Lou Biblowitz used in setting the ratio of exchange of Masters and Lady Rose stock; e.g. (a) That no value was assigned to the Masters tax loss carryforward of $3,378,849 although that loss carryforward was an important reason for his deciding upon the merger(and in fact it was utilized in full for tax savings of $1,905,000 by the surviving company) (133A-134A); (b) That he arbitrarily deducted $900,000 from the Masters book value (Book value was $1,677,000 (75A), TR 1400, 782) ; (c) That no value was attributed to Masters as the landlord who could terminate Lady Rose's concessions in the Masters stores, even though that vulnerability of Lady Rose to Masters' power was also an important reason for his wanting the merger (TR 1472, 125A, 3rd ¶ last sentence, 123A, 2nd ¶); (d) That for purposes of the merger, he valued Masters at only $777,000 and Lady Rose at $6,000,000 without obtaining any independent appraisals (TR 1400, 136A). Put simply, the Biblowitzs were offering to buy Masters at $777,000 and to sell Lady Rose at $6,000,000 and neither was disclosed.

7. <u>Kalish Rubinroit & Co.'s Role.</u> Although the proxy statement disclosed that that firm were the accountants for both Masters and Lady Rose, it failed to disclose that

these accountants were - instead of taking a neutral position vis-a-vis Masters and Lady Rose, which is the duty of a professional in a conflict position - secretly working to obtain the maximum advantage to the Biblowitzs in the merger.*

8. Feldshuh & Frank Role. Feldshuh & Frank were in a conflict of interest position as attorneys for both Masters and Lady Rose (J. Biblowitz, TR 479-80) and, as they naturally expected to remain as the attorneys of the surviving corporation, controlled by the Biblowitzes, which in fact took place, the independence of their judgment and opinion was compromised. Thus, Feldshuh & Frank were in no position to protect the interests of Masters. The above facts were not disclosed in the proxy statement. The lawfirm of Flaum, Growman, Sassower, Rosenberg and Postel acted as special counsel for Lady Rose.

9. One Of The Directors Of Masters Voted Against The Merger And Several Directors Stated That Masters' Value Was At Least Equal To Lady Rose's. The stipulated fact was

* That they were working in the Biblowitz's interest, not that of Masters, in the merger matter is plain. They worked on the matter exclusively with Lou Biblowitz (TR 790-1, 212), they received additional compensation for these services from the Lady Rose division - not disclosed to the stockholders (136A, ¶10(c); and they failed to disclose to Masters that under an earlier plan of merger it had been proposed to give the Masters public stockholders twice (about 20%) as much as they were given in the final plan (about 10%) (209A-212A; 130A). Kalish, Rubinroit were personal tax advisors to the Biblowitzes (TR 1418-9), and were retained by the surviving company under Biblowitz control (136A, ¶10).

that Mr. Kurtz, a director of Masters, voted against the merger at the Board of Directors meeting on the ground that he disagreed "with the values that were reached as a basis for the merger" (134A). Mr. Kurtz's negative vote and the reason for it were not disclosed to the stockholders. The covering letter from Louis Biblowitz as Chairman of the Board of the Directors of Masters sent to the stockholders with the proxy statement stated:

> "Your Board of Directors has approved a merger agreement whereby LADY ROSE STORES INC. will be merged into and acquired by MASTERS INC. Your Directors recommend your approval of this merger as being in the best interests of the stockholders of MASTERS INC.
>
> * * * * *
>
> "Your Directors believe that the terms of the merger are fair and equitable." (80A)

The proxy statement did not disclose that at the Masters Board meeting, some of the directors expressed the belief that the value of Masters for the purposes of the merger should have been $3,200,000, not $777,000, and

> "Several of the directors stated that it appeared that the value of Masters was equal to or greater than that of Lady Rose and that the proposed issuance of 1,750,000 shares of common stock and 1,750* shares of preferred stock of Masters for all of the stock of Lady Rose should be reduced." (Stipulated Fact, 134A-135A)

10. Masters' Financial Condition. On the issue of materiality, the District Court speaks of "the poor financial condition of Masters I at the time the merger was approved" -

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* Convertible into 1,750,000 shares of common stock on February 1, 1973.

with a reference to footnote "3" -, which "was generally known to the stockholders" - with a reference to footnote "4". (15A) Footnote 3 (67A) states "See pp. 17, infra". Page 17 (26A) of the Opinion does not discuss any evidence on the alleged "poor financial condition" but merely repeats the Court's prior conclusory statement about the company's "poor economic condition".

Regarding the Court's statement that "this condition was generally known to the stockholders",it cites footnote 4 (68A) which refers to "Masters' history of financial difficulties ... set forth in the proxy statement". The Court then refers to page 5 (85A) of the proxy which discusses the petition for arrangement filed in 1963 - clearly this was ancient history and had no bearing on the Masters financial condition in 1966. The Court next refers to the proxy, page 9 (89A) which discusses Masters' tax loss carryforward ($2,474,000 of $2,579,000 was derived from fiscal years ended prior to May 2, 1964 (103A) and all of the balance of losses were from its discontinued Florida operations (143A)) and FS 2-3 (96A-97A), Masters' statements of income. The Court then states "Even if, as plaintiffs claim, the income statement should have explained that some*of Masters' prior losses were attributable to discontinued operations, the income statement correctly revealed that Masters had had a history of substantial losses." That

* Emphasis supplied throughout, unless otherwise noted.

statement by the Court is meaningless without identifying what part of Masters' losses were attributable to discontinued operations. The Court overlooked the stipulation of the parties in open court (TR 321-333, 143A). It was stipulated that Masters for the period May 1, 1964 through July 30, 1966, for its metropolitan area stores, its only continuing operations as of July 30, 1966, had an operating profit of $110,999 (data stipulated at trial, 143A, TR 327-31). However, the discontinued Florida division of Masters for the same period May 2, 1964 through July 30, 1966 showed an operating loss of $379,850 (stipulated facts, 143A, ¶(b)16, TR 321-6). Masters also incurred a non-operating loss of $561,367 on the sale of its Florida division in July, 1966 to Zayre (131A). Accordingly, the discontinued Florida division showed total losses of $941,217 since May 2, 1964 against a profit from operations of $110,099 from Masters' metropolitan stores.* Therefore, the operations of Masters, in proper perspective, demonstrate that the continuing operation of Masters instead of representing a "history of substantial losses" represented, as stipulated by the parties, a profitable operation and all (instead of "some") of Masters' losses since May 2, 1964 were attributable to its discontinued

* Only the loss on the sale of its Florida division to Zayre was separately disclosed to the stockholders of Masters (102A, note 8); otherwise, the operating data for the discontinued and continuing operations were combined.

Florida operation. That is substantially different than the characterization by the Court below that "some of Masters' prior losses were attributable to discontinued operations ..." (footnote 4). The District Court erroneously believed, without citing operating statistics, and contrary to the stipulated facts, that "some" of Masters' prior losses were attributable to discontinued operations when in fact it was "all", since May 2, 1964 (the start of the first year of operations after the confirmation of the plan of arrangement on December 27, 1963 (DX AL, note 2)).

Therefore, the Court is relying upon defendants' misrepresentation in the proxy statement to support its conclusion that Masters was in poor financial condition and that such poor financial condition was known to the stockholders.

In fact, the overwhelming evidence demonstrates that Masters was not in a poor financial condition, as of November 7, 1966, the date the Masters Board of Directors approved the plan of merger:

(i) On August 24, 1966, Louis Biblowitz, as Chairman of the Board of Masters, advised the shareholders of Masters that as a result of the sale of the three Florida stores, "your Company today is in a good working capital position" and "Your Company's efforts in the future, we anticipate, will enable the Company to continue to stabilize its position in the merchandizing field"* (150A).

* This demonstrates clear error by the Court in holding that "Masters' financial condition in 1966 ... after the sale of the three Florida stores to Zayre Corp., was precarious" (33A).

(ii) As of July 30, 1966, the working capital of Masters was $1,856,595 and the working capital of Lady Rose was $1,821,070 as of August 31, 1966 (39A) - for all practical purposes the same.

(iii) "As of September 6, 1966 Masters had a remaining indebtedness to Chapter XI creditors (originally $1,400,000) of $393,000 and payments under the plan of arrangement would in the ordinary course be completed on or about November, 1967" (Stipulated Fact, 131A; 38A). On August 24, 1966, Louis Biblowitz advised the Masters stockholders: "This will be liquidated within the course of the next fifteen months." (150A)

(iv) Louis Biblowitz told the Board of Directors of Masters in connection with the proposed merger of Lady Rose and Masters, _inter alia_, that the earnings of Masters projected to January 31, 1967, would show, according to the opinion of the Secretary-Treasurer, a "break-even" or at best, a small profit. (Stipulated Fact, 134A).

(v) As a consequence of the sale to Zayre, Masters had a stated net cash inflow of approximately $1,508,000 _after_ a full retirement of its Subordinated A and B Debentures in the amount of $250,000 and $162,000; the stockholders' equity would be approximately $1,870,000 (PX 113, p.2).

(vi) The 6% Series A and B Debentures of Masters in the amounts of $250,000 and $162,000, respectively, were

subordinate to all sums due or to become due under the plan of arrangement and to future bank and other institutional loans obtained for operational purposes (Stipulated Fact, 138A). Despite its senior position, "the Creditors Committee in August 1966 consented to the payment in full by Masters of the 6% Series A and B Debentures ..." (Stipulated Fact, 138A).

(vii) Lou Biblowitz was confident he could turn the Masters operation around and produce a profit; he reached that determination after Masters' Florida stores were sold to Zayre. (Kopelson TR 908, Lou Biblowitz TR 789-40, J. Biblowitz TR 457). Lou Biblowitz believed that in fact expenses of the two companies would be cut if the two companies merged. (J. Biblowitz, TR 456-7)

(viii) The chief financial officer of Masters testified that Masters on November 7, 1966 was not facing bankruptcy (Kopelson TR 932); that is supported by his statements to the Board on November 7, 1966 (119A).

Therefore, contra the testimony relied upon by the Court below (34A), Masters was not "headed for another bankruptcy". The documentary and contemporary evidence prepared in the regular course of business was direct, objective, and unmistakeable proof that Masters was not threatened with bankruptcy at the time of the merger.

11. The Representation That The Merger Was "Fair And Equitable." The proxy statement stated that in the opinion of the directors the merger was "fair and equitable"

but it did not disclose that Lou Biblowitz, sitting on both sides of the bargaining table, had, by the merger agreement, decided to buy Masters for $777,000 - less than 50% of book and nothing for the tax loss carryforward or for surrendering its relationship of landlord to a concessionaire with the latter's vulnerability to cancellation - and sell Lady Rose for $6,000,000. Giving the conclusion of the one sitting on both sides of the bargining table, while not disclosing that he did,and not disclosing the buying and selling prices,was a blatant omission, whether or not those prices were fair.

Moreover, since the Court below determined that the terms of the merger were fair to the Masters stockholders, it held that there was no material misrepresentation on that issue (24A-25A). We contend below that the transaction was in fact unfair, inequitable and unconscionable. Accordingly, said represention also constituted a material misrepresentation.

B. Unfairness Of The Terms Of The Merger.

Lou Biblowitz, fixing the terms of the merger, gave himself and his family approximately 90% of the surviving corporation and 10% to the minority stockholders.*

* Lou Biblowitz was less than candid when he pretended that 80% for the Biblowitzs and 20% for the Masters public stockholders as originally proposed was equivalent to 90% for the Biblowitzs and 10% for the Masters' public stockholders, as finally adopted, and that he didn't understand current ratios. (L. Biblowitz TR 1417-18, 1421-4, PX 32)

1. <u>Masters' Tax Loss Carryforward.</u> The Biblowitzes included nothing in the ratio of exchange for Masters' tax loss carryforward (23A, 26A), although they arranged the plan of merger so as to take full advantage of the tax loss carryforward (46A, 48A). The tax loss carryforward "was fully utilized by the merged company in the fiscal years 1968, 1969 and the first month of fiscal 1970; Masters saved, respectively, in taxes, $700,000, $1,148,500 and $56,500 for a total saving of $1,905,000." (133A-134A) Through its ownership of approximately 90% of post-merger Masters, the Biblowitzes received a cash benefit of approximately $1,700,000 from the pre-merger Masters' tax loss carryforward.

The Biblowitzes knew that in Masters' tax loss carryforward, they were acquiring an important asset. Under the original plan of merger the Biblowitzes were to receive less than 80% of the common stock with the remaining Masters stockholders to receive approximately 20% of the Masters' common stock, because for every 1% of the common stock above 80% received by the Biblowitzes, 5% of the Masters' tax loss carryforward would have been lost (210A). But thereafter the accountants and lawyers for the Biblowitzes conceived a technique which would permit the Biblowitzes to retain the equivalent of 90% of the equity of Masters without forfeiting any of the Masters' tax loss carryforward (52A). This was

accomplished by issuing 1,750 shares of 5% non-cumulative, non-voting, preferred stock of Masters to Lady Rose that was convertible into 1,750,000 shares of common stock of Masters on February 1, 1973. The non-voting preferred stock did not reduce the Masters' tax loss carryforward. Kalish, Rubinroit informed the Masters Board on October 31, 1966, that in their opinion and subject to an IRS ruling, assuming Lady Rose's continued performance as projected, the entire tax loss carryforward would be utilized by the surviving corporation (132A-133A). Special tax counsel was retained by Masters to obtain a ruling from the IRS prior to the merger, which would permit the surviving corporation to utilize the tax loss carryforward (PX 25, a 25-page letter). A favorable oral ruling from the IRS was in fact obtained prior to the merger (133A); subsequent to the merger that oral ruling was confirmed by a written ruling from the IRS in February of 1967 (124A) and special counsel for Masters upon receipt of that ruling stated (123A) "... The ruling sets forth as a statement of fact, the important, genuine business reason for the merger, thus making it virtually certain that Section 269 cannot be held applicable to deny Masters Inc., the net operating loss carry-overs otherwise available" (123A).

Where a company is desired in part because of its tax loss carryforward of $3,378,849 (132A-133A), which in relatively short order is utilized in full for a cash benefit of $1,905,000, the pertinent question is not, does it have

value in a merger ? an affirmative answer is so obvious, but, rather, how much value ? Under the circumstances Mr. Rosenthal's testimony "that <u>he</u> knew of no way to assign a value to a tax loss carryforward and that <u>he</u> knew of no instance in which a value had been assigned to a tax loss carryforward" (46A) is of no significance.* Plaintiffs' expert, Leonard Marx, applied a published technique (article entitled "How Much Are Tax Losses Really Worth" DX AB, 173A) to arrive at the value of the Masters tax loss carryforward, which he gave as $800,000 (173A). Thus, he utilized a 7% discount rate in bringing his projected savings down to present values (173A, TR 1378); he assumed a tax rate of 35% (173A, TR 1373-4); he deducted nothing for legal expenses or a probability of losing a court case because the company had a tax ruling (124A, stipulated fact 133A, 8th line, 135A) and special tax counsel advised (123A) that the ruling made it "virtually certain that Section 269 cannot be held applicable

* Underscoring supplied. Mr. Rosenthal, the principal in the firm of L. M. Rosenthal & Company Inc., was the underwriter for the stock offered by Masters and the Biblowitzes (and some small stockholders) in a public offering in 1969. In addition, after the underwriting, Mr. Rosenthal became a director of Masters which he knew to be controlled by the Biblowitzes (as per the prospectus, 146A); he was a director of Masters at the time his testimony was given; Rosenthal & Company had purchased 55,000 shares of Masters' stock from the Biblowitzes pursuant to an agreement dated April 9, 1968 (145A); Mr. Rosenthal at the time of his testimony was therefore under the influence of Mr. Biblowitz; Mr. Rosenthal had no independent recollection of events that took place in 1966 during meetings with the Biblowitzes and their representatives (TR 1057-9).

to deny Masters Inc., the net operating loss carry-overs otherwise available". The estimate was conservative, particularly since he assumed only a 35% tax rate, whereas the actual tax rate turned out to be 48%, involving much greater tax savings due to the use of the loss carry-overs (173A, TR 1199, 1201).

Defendants' expert, Martin J. Whitman, stated that the tax loss carryforward had slight value. His reasons expose the baselessness of his opinion:

(i) "Masters tax returns had only been reviewed through April 30, 1963 and, consequently, the size of the carryforward could only be estimated." (65A) The conclusive answer is that there was nothing in the record which indicated that the size of the Masters carryforward was not correct and Mr. Whitman offered no such evidence; moreover, the parties stipulated that on October 31, 1966, Louis Biblowitz told the Board of Directors of Masters that "the company has a carry-forward loss of about $3,378,849 ..." (134A); "As of October 30, 1966, the projected tax loss carryforward of Masters for the fiscal years 1963 through 1967 was $3,378,849" (132A); the plan as presented to the directors stated (74A): "The plan has been drafted to qualify the carryforward loss of Masters of approximately $3,378,849 as a net operating loss deduction against the future earnings of the merged companies;" in addition, the tax loss carryforward was in fact utilized to

the extent of $3,900,000 for an actual saving as recorded by the Court of $1,905,000 (70A).

(ii) "It was uncertain whether a combined Masters-Lady Rose operation would enjoy sufficient profits to fully utilize the carryforward" (65A). Again defendants' expert's argument was far outweighed by the actual utilization of the loss carryforward within 25 months; the proxy stated (88A, ¶2): "tax benefits are expected to result"; defendant's expert's guess was contrary to the stipulated statement made by the accountants for Masters and Lady Rose at the Masters Board meeting on October 31, 1966 that (133A): "... assuming that the pattern of performance of Lady Rose continued in the projected amount of $600,000 annual earnings, then the aforesaid carryforward loss would enable all earnings of the merged company to be after tax earnings, to the full extent of said loss." Moreover, defendants' expert was taking an inconsistent position: in valuing Lady Rose he was assuming that the earnings of $600,000 would continue in the future but in evaluating the tax loss carryforward he raised the question of whether the combined Lady Rose, Masters operation "would enjoy sufficient profits to fully utilize the carryforward". Again, reality comes into play; the pretax income of the combined Masters-Lady Rose operation permitted full utilization of the carry-forward loss within 25 months (133A-134A).

(iii) "Lady Rose would also have to assume the obligations of Masters I, including the obligations to the

Creditors' Committee" (65A). But Masters' obligation to the Creditors Committee, like its other obligations, was already deducted in determining Masters' net worth at July 30, 1966 at $1,677,438 (75A); by considering it again in connection with the tax loss carryforward, Whitman deducted it twice. Moreover, the Court found (38A) that: "As of September 6, 1966, Masters had remaining indebtedness to Chapter XI creditors (originally $1,400,000) of $393,000 and payments under the Plan of Arrangement would in the ordinary course be completed on or about November, 1967." In fact, the last payment was made to the Creditors Committee in April 1967 (J. Biblowitz TR 476-7). Furthermore, Masters' working capital (current assets minus its current liabilities), as of July 31, 1966, was in excess of $1,800,000 (39A).

(iv) Under §269, IRS might contest use of the loss carryforward (65A-66A). This has already been answered above, p. 18. There was no indication they would; the indications were all the other way. In fact they did not.

(v) "Finally, Whitman reported that it could be anticipated that Lady Rose would enter a higher tax bracket after the merger since it could no longer file unconsolidated tax returns ... according to Whitman, this tax disadvantage would help offset any advantage to be obtained from Masters carryforward." (66A) Analysis demonstrates that the fact was not very significant since Mr. Whitman was talking about five years beyond which the tax loss carryforward expired,

which makes it far more uncertain than the tax loss offset. Furthermore, it is inconsistent with his previous argument that "it was uncertain whether a combined Masters-Lady Rose operation would enjoy sufficient profits to fully utilize the carryforward" (65A). In reality, the fact that Lady Rose was prepared to give up its lower bracket of 33% and accept a higher bracket of 48% demonstrates by its conduct how certain it was that tax benefits would accrue under the merger. Moreover, that item was considered when plaintiffs' expert used a tax bracket of only 35% in arriving at the value of the tax loss.

Defendants' expert did not test his projection of slight or zero value for the loss carryforward against the actuality that none of the contingencies he mentioned matured; inconsistently, he had selectively checked other assumptions of his against actuality when it was to his client's advantage. (e.g. 199A, middle). Defendants' expert failed to state any objective facts to justify his appraisal of the tax loss carryforward.

Thus, the Biblowitzes by taking 90% of the surviving company obtained, from utilization by it of the full loss carryforward with a tax saving of $1,905,000, a benefit of $1,700,000 for which they paid nothing. (M. Biblowitz TR 361-3) The cash generated from utilization of the tax loss carry-forward permitted the surviving company to seek out new opportunities for investment (Rosenthal TR 1073). The cash

savings from the loss carryforward's offsetting earnings, in computing income taxes, put the surviving company in an exceptionally strong working capital position; defendants' expert conceded that great weight should be placed on the working capital position of a company (Whitman TR 1873-4).

2. Valuation of Masters. In the opinion of plaintiffs' expert, the fair value of Masters as of November 15, 1966 was $2,200,000 (172A) plus $800,000 for its tax loss carryforward (173A) for a total value of $3,000,000 (154A). Plaintiffs' expert then deducted $450,000 from that amount for Lady Rose's 15.1% interest in Masters, which reduced the value of Masters for the purposes of the merger to $2,550,000 (154A). Lou Biblowitz assigned a price of $777,000 to Masters for the purposes of the merger (TR 1400, 782); the lower Court accepted that Biblowitz valuation as fair even though Lou Biblowitz arbitrarily picked a value of $1.71 per share for Masters out of a group of different values submitted to him by his accountants; he thus took a discount of $900,000 from its book value (L. Biblowitz TR 782, 1400) and defendants' expert stated that the fair value of Masters, without the shares owned by Lady Rose, "was not more than $500,000"(198A)

Plaintiffs' expert stated (174A):

> "The Masters' shareholders, if they had been given the pro forma numbers without the losses of the disposed of Miami units, would have felt the stock was now a good speculation: the financial condition was solid; the losses had at least been stemmed; and proven capable retail management with a significant stock interest was now at the helm. Under such conditions one awaits developments rather than selling out -- unless the suitor makes a very attractive proposal."

With respect to companies in Masters' position in the industry, plaintiffs' expert stated (174A-175A):

> "The companies that controlled and operated the discount department stores sold at somewhat higher valuations (price-earnings multiples) but more important it was a sellers market for the companies that controlled the stores and hence the revenues. Even unprofitable units could be readily sold to strong lessees who knew the stores since they operated departments in them (i.e. Spencer Shoes, Daylin Drug, Barbara Lynn, and Unishops.) Lady Rose was ready to merge with Masters now that Masters' losses had been stemmed and it had adequate working capital and almost no debt.
>
> * * * * *
>
> "Thus I conclude that an independent Board of Directors of Masters would not have approved the transaction unless they received a premium over established values. They probably would have insisted on and obtained a 50% interest in the merged companies, which would have been a 10% premium over the valuation shown on the above table. However, to be conservative, I have retained the appraisal of ... Masters at $3 million for purposes of the merger."

Mr. Marx further stated (154A):

> "In my opinion a final figure of 38% for the public shareholders of Masters would have been acceptable to Lady Rose and the merger would have been consummated on those terms."

Every contemporaneous acquisition of an entire company analyzed for market price showed that book value or more was obtained. (172A; Marx TR 1195)

Floyd Bennett, in the New York area, was acquired by one of its concessionaires, Spencer Shoe, for $2,000,000,

two times its book value (Marx TR 1179-80) and had its debt of $1,400,000 guaranteed by Spencer, (Marx TR 1312) even though Floyd Bennett lost $237,000 in the first 22 weeks of 1965 against a loss of $141,000 for the previous year and $288,000 for fiscal 1965; and had a negative working capital of $1,016,000. (167A, par. 4; Marx TR 1175-7) The basic appeal to Spencer Shoe in the acquisition of Floyd Bennett was the prospect of controlling $35,000,000 of sales with the prospect of turning a loss into large profits by a relatively small turn (Whitman TR 1823).

Marrud (a leased department operator) controlled 78 million dollars in sales; although in Chapter XI with a loss of $5.94 million, it sold in the market at $1.8 million which was 1.3 times its book value; the market concept was that with $78 million in volume a slight change in the profit margin would result in a substantial profit (Marx, TR 1217-8,157A).

In the case of S. Klein, the market and Mr. Riklis were willing to pay a premium for the retail volume controlled with a small capitalization (171A; Marx TR 1251-4).

Masters, including the leased departments, controlled $18,000,000 in annual revenues (165A).

Considering the Marrud sale at 1.3 times book value and the Floyd Bennett sale at two times book value, the valuation of Masters, apart from the value added by the tax loss carryforward, at 2.2 million dollars, i.e. 1.3 times

book value and 12% of store revenues, is under all the circumstances objectively fair (172A; Marx TR 1195). Thus Masters' tax loss carryforward of $3,378,000, working capital of $1,800,000, book value of $1,677,000 and long-term debt of $400,000 clearly indicate that the value of $3,000,000, placed on Masters by plaintiffs' expert, before deduction for Lady Rose's interest in it, was reasonable.

The determination of the going concern value requires consideration of book value, working capital, annual sales, rentals from concessions,cost of good sold, projected improvements in one or more of the foregoing, tax loss carry-forward, and other pertinent circumstances of Masters' business as valued by the market. (163A-172A; Marx TR 1157; Whitman TR 1942-3) Plaintiffs' expert, in decisive contrast to defendants' expert, supported his valuation of Masters by reference to comparable market data (163A-172A, TR 1157 cf. 198A-208A). Both parties agree that the price-earnings ratio method of valuation does not apply in valuing Masters because no net income was projected for Masters for the fiscal year ended January 28, 1967 (163A et seq.; 198A et seq.).

Masters' working capital (i.e. current assets less current liabilities) at July 30, 1966 was $1,857,000. (39A) Masters' working capital position was stated by Lou Biblowitz to be good; (150A) it was as strong as that of Lady Rose. (39A M. Biblowitz, TR 353-5) Eliminating the Miami operation of

Masters sold July 1966, there was projected for the balance of the fiscal year ending January 28, 1967 a breakeven (113A).

Plaintiffs' expert's projection for Masters of at least $400,000 pre-tax was reasonable based on inter alia his estimate of a reduction in the 1968 cost of goods sold; (Marx, TR 1244, 1247, 164A-165A) increased rentals from leased departments based on higher percentages from the mens' and boys' concession, (from 8 1/2 to 10%) the shoe concession, (from 9 to 11%, PX70) and the probability of an increase in the ladies' and childrens' wear concession (162A); projected improvement in management; elimination of the Miami units; and the fact that Masters was adequately capitalized after the Miami sale, on the basis of working capital to revenues and shareholders' equity to revenues. (Marx, TR 1249-51, 165A)

Mr. Rosenthal, a prospective underwriter called in by the Biblowitzes with a view to a possible underwriting at one time, recorded on July 7, 1966 the projection to him by representatives of Lady Rose that in fiscal 1968 Masters should earn $800,000 pretax and $400,000 net after taxes (PX 14, p.1, bottom); also $1,600,000 pre tax net of combined company, projected for fiscal '68, included $800,000 pre tax income for Lady Rose and $800,000 for Masters, p. 2 bottom) The profit projection for Masters' metropolitan stores for the 3 months ending January 28, 1967, of $174,000* in Max Biblowitz's

* While Masters showed a loss of $360,000 for its metropolitan stores for the fiscal year ended January 28, 1967, that loss must be viewed in the context that the report was issued on May 8, 1967 (DX F), after the Biblowitzes knew that plaintiff stockholders of Masters through their counsel had taken the position that Masters was seriously undervalued in the merger; (footnote continued on next page)

handwriting on PX 13), was evidently based on a profit of $174,000 from actual operations for the comparable three months ended January 29, 1966 (PX 13, M. Biblowitz, TR 338-341; 346-351, PX 132).

When Zayre purchased the Florida stores, it viewed the Masters, Lady Rose, Rockower operation there as one (M. Biblowitz, TR 381-2) and after the purchase, operated the hard goods and soft goods departments without concessions. (M. Biblowitz TR 382)

The Rockower and Lady Rose operations in the Masters' New York metropolitan stores, consolidated with the Masters' metropolitan operation, show a metropolitan pretax profit of about $550,000 for the 2 1/2 years ending July 30, 1966 (M. Biblowitz, TR 382-3)

An integrated company operating in the New York area was in a position to acquire Masters' metropolitan stores and take over direct operation of the concessions of Lady Rose and Rockower, utilizing the acquisition to cut unit advertising and overhead costs (M. Biblowitz TR 383-4, 390-1). If the Masters stores were sold to an entity other than Lady Rose, the Lady Rose concessions in the Masters' metropolitan stores would be vulnerable to discontinuance; one of the reasons for the merger was its guarantee to Lady Rose of the continuance of its business in the Masters stores (125A, 3rd ¶, 123A, 2nd ¶). In any bona fide sale of its assets, Masters had the right, on

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(continuation of footnote from preceding page)
in addition, there was an incentive to write down the Masters inventories in fiscal 1967 with a view to maximizing losses and thereby assuring that Masters in the future would operate profitably and be better positioned to utilize the tax loss carry-overs.

relatively short notice, to terminate any of its concessions (PX 69, ¶(17K); PX 148, pp. 9-10, ¶18(K)). This was an asset of Masters; no value was assigned to it.

It was to the interest of Lady Rose that whoever took over Masters would be friendly to Lady Rose and would desire that Lady Rose be kept as a concessionaire for the metropolitan stores (J. Biblowitz TR 459). Prior to the October 31, 1966 meeting of the Masters board, Masters did not aggressively pursue merging with other companies (Kopelson, TR 917-9). The only companies approached by Lou Biblowitz were those which would virtually assure Lady Rose that its concessions in the Masters metropolitan stores would continue (TR 917-9, 783-6, 309).

Some of the directors of Masters believed that the value of Masters, apart from the tax loss carryforward, was book value at July 30, 1966, i.e. $1,677,438 and that its value, including the tax loss carryforward, was $3,200,000 (Stipulated fact, 135A, L. Biblowitz TR 1402). The only fair inference is that those directors voted for the merger only because the Biblowitzes controlled them.

The operating loss for the discontinued Florida division of Masters was $380,000 for the period May 2, 1964 through July 30, 1966, of which $371,000 was incurred between May 1, 1965 and July 30, 1966 (Stipulated fact 143A, (b)16, TR 321-6). The Florida stores had been an incubus on the

Masters operation (TR 874). Lou Biblowitz was considering merging Lady Rose and Masters only after Masters agreed in principle to sell off the Florida stores to Zayre (PX 122, PX 119, 209A, L. Biblowitz TR 791-7). That conduct by Mr. Biblowitz was persuasive evidence that there were substantial advantages in Lady Rose's merging with Masters once Masters was free of its losing Florida operation.

As a result of the sale of the Florida stores of Masters, the Series A and B debentures of Masters in the respective amounts of $250,000 and $160,000 were paid off, even though those debentures were junior to Masters' obligation to the Creditors Committee. Since the Creditors Committee felt adequately secure that the balance of over $400,000 owed to it would be paid off in the regular course of business, it gave its consent (M. Biblowitz, TR 404).

After the sale to Zayre the overhead from the Masters Miami division that had to be absorbed into the New York metropolitan stores was not too significant (Kopelson TR 837-8). Mr. Kopelson, as the chief financial officer of Masters, was of the opinion that with the elimination of the Florida stores, Masters would be in a position to move towards expanding operations in the metropolitan area, (Kopelson TR 932) which would reduce unit overhead costs including advertising costs (Kopelson TR 837-8). Locating a fifth store in the metropolitan area would reduce Masters' advertising and overhead expenses for each of its stores in the metropolitan area (M. Biblowitz TR 223-4, 226). Mr. Kopelson recommended that

additional stores should be opened in the metropolitan area; he also referred to an enlargement of the Elmsford store (Kopelson TR 830-1). He prepared a pro forma projection contemplating 5 and 6 stores in the metropolitan area (Kopelson TR 831-2, PX 12). He projected that for the fiscal year ending January 29, 1968 Masters with 4, 5 and 6 metropolitan stores would earn a pre-tax profit of $162,000 $352,000 and $552,000, respectively (Kopelson, TR 832-3).

Mr. Kopelson recommended the aggressive search for small chains within the Masters mercantile area that could be merged or acquired, or the expansion of Masters to a minimum of five stores (Kopelson TR 876). On October 31, 1966 he projected a breakeven or at least a small profit for the Masters' metropolitan stores for the six months ending January 28, 1967 (Kopelson TR 834), based on the profit of $105,000 for the six months ended January 29, 1966 and on the operation to the date presented (Kopelson TR 835-6). That was a realistic projection by the then operating head of Masters, based as it was on the current operations of Masters' metropolitan stores and on the comparable six months of the preceding year. From 1963 to the date of the merger Mr. Kopelson was the individual most familiar with the financial situation of Masters (Kopelson, TR 841). His projection to the Board of Directors on October 31, 1966 about Masters being a breakeven operation at least or showing a small profit

for the six months ending January 31, 1967 represented the best objective appraisal of the then current operations of Masters.

After the termination of Mr. Haizen as President of Masters in early September 1966, a partner of Kalish, Rubinroit advised Mr. Kopelson that he had a very good future at Masters and advised him to stay, that the Biblowitzes would take a more active interest and work harder for Masters and would devote the same energies to operating Masters as they did with Lady Rose. (Kopelson TR 827-8) Lou Biblowitz told Kopelson and others in the Fall of 1966 after terminating Haizen, that, having sold off the loss operations in Miami, he could turn the remaining operations around, if management worked harder (Kopelson TR 829).

Being the landlord was of primary importance to Lou Biblowitz (L. Biblowitz TR 1472); he also wanted the Masters name (L. Biblowitz TR 790); by merging with Masters, Lady Rose eliminated the risk of losing its concessions in the metropolitan stores of Masters (L. Biblowitz TR 1475, M. Biblowitz TR 232).

In valuing Lady Rose, Lou Biblowitz did not take into consideration the fact that Lady Rose concessions in Masters' metropolitan stores were due to expire on January 31, 1967 (L. Biblowitz TR 799). For the purpose of the ratio of exchange, he placed an approximate value of $800,000 on Lady

Rose's concessions in the Masters' New York stores and an additional $600,000 on its concessions in the Masters' Florida stores by taking ten times his own estimate of earnings for fiscal 1967 even though the Florida stores had been previously sold (L. Biblowitz TR 800-2; 804-5, 807; M. Biblowitz TR 364-5). In addition, Masters was charged $725,000 for estimated earnings of Lady Rose that were non-existent and never materialized because Lady Rose's net income for the eleven months ended January 28, 1967* was $527,000, instead of $600,000 as projected, (including discontinued Florida). (M. Biblowitz TR 365-6, 368)

Lou Biblowitz believed that in acquiring Masters he could make it profitable (Whitman TR 1973); hence his willingness to put the assets of Lady Rose against the obligations of Masters. He believed that the merger would constitute a quantum jump (Whitman TR 1973); this, of course, would give the Biblowitzes the advantages of Masters' control over $18,000,000 of sales. Lou Biblowitz, disregarding the advice of many persons, decided to merge Lady Rose and Masters because of the many advantages to Lady Rose (Rosenthal TR 1050).

Lady Rose and Masters, as a result of the merger, were going to be participating in a larger company, with greater retail sales, good working capital, and greater equity, which would permit the surviving company to grow and expand. (Kopelson TR 892) Masters was in fact making a substantial

* Income for the month of February 1967 was not significant (148A,see double asterisk).

contribution to this surviving company. Plaintiffs' expert fairly valued that contribution at $2,550,000.

The report submitted by defendants' expert failed to state a date as of when his valuation was being made (Whitman, TR 1856). On his direct testimony, defendants' expert stated his valuation date was as at October 1966 (Whitman, TR 1854). On cross-examination, it was demonstrated that defendants' expert inconsistently used different dates for valuing Masters and Lady Rose depending on what was best for his clients (Whitman TR 1855-6). Defendants' expert failed to make clear his assumptions and projections for the Masters' operation for the fiscal year 1967 (TR 1856-1866). He failed to take into consideration Biblowitz's projections of Masters' earnings favorable to Masters (TR 1961-3, PX 13, PX 14); he did not take into consideration Lou Biblowitz's expressed conviction that he could turn Masters around (TR 1974); he expressed unfamiliarity with the improvement in certain concessions through Perry Shoes and Merco and lack of knowledge about Rockower, Masters' second most important concessionaire (TR 2082-4); he was therefore not sufficiently informed to make the statement that Masters was not in a position to attract new concessionaires.

Defendants' expert showed insufficient knowledge about the transactions he cited in attempting to challenge certain parts of the report of plaintiffs' expert (Whitman, TR 2094-7); his criticisms of the Marx report were insignificant

or based on insufficient information (TR 2099 (bottom) to TR 2101 (middle)); and were not such as to impair the validity of plaintiffs' expert's conclusions as to the values of Lady Rose and Masters.

Defendants' expert assumed, without factual justification and in face of the Zayre take-over of concessions when it bought the Miami stores and Masters' take-over of the Rockower concessions after the merger with Lady Rose, that in an arms length transaction with Masters, the profitable concessions of Lady Rose and Rockower would not have been taken over by the stores' owner (TR 2097-9).

At the time of the trial the defendants' expert was employed by Stanley Marks & Company; his position there was not that of a financial analyst but as a customer's man or, in the vernacular, a stock broker salesman (TR 2093-4). He was a vice president with Blair & Company when that company went broke (TR 2094). He stated that he was doing financial analysis on his own at the time of the trial (TR 2093). Defendants' expert did not submit his appraisal as a research analyst familiar with the values that the market placed on businesses like Masters and Lady Rose (TR 1897-8). Defendants' expert did not cite any market data to support his valuation of Masters; it was simply a sworn argument (198A-208A).

Mr. Rosenthal could not state from his notes or otherwise what information was given to him about the Masters

operation and he could not testify whether or not he had any information about Masters' losses in Florida (Rosenthal, TR 1057-9); without such information, Mr. Rosenthal's calculations in DX X on the value of Masters are entitled to no weight.*

The Court below erroneously relied upon testimony of interested witnesses that "poor mouthed" the condition of the Masters stores, financial condition and inventories (32A-35A) in contrast to what was objectively reflected about them in the operations reports of the Masters metropolitan stores (144A). The District Court thus adopted a subjective analysis without market data (as by defendants' expert, 198A - 208A) and rejected an objective analysis provided by plaintiffs' expert, which was supported by market data (163A-175A)**

* Moreover, Mr. Rosenthal at the time was working with his clients, the Biblowitzes, for an underwriting, then or in the future.

** For example, the Court characterized the financial condition of Masters <u>after</u> the sale of its three Florida stores in 1966 as "precarious" when in fact in another part of its opinion the Court stated as a fact that the working capital of Masters at that time was the same as the working capital of Lady Rose (39A) and was characterized by Lou Biblowitz in a letter to the stockholders as "a good working capital position" (150A). Moreover, the District Court in accepting testimony about the Masters Flushing store and Elmsford store (32A-33A) failed to appreciate that the Lady Rose units in those stores were the third and fourth most profitable units in the Lady Rose operation in fiscal 1966 (DX AU, pp. 12-13). Furthermore, the District Court treated the meetings between the Biblowitzes, their counsel, their underwriter and their accountants (44A-45A) as though there were representatives of Masters present, but in fact these were meetings between the Biblowitzes and their own advisers planning the means by which the Biblowitzes were to obtain the maximum in the surviving corporation at the expense of (footnote continued on next page)

The Court considered the price paid by the Biblowitz group for control of Masters on or about April 11, 1963 (29A) when that group purchased a majority interest in Masters at $1.15 per share (31A). It is significant that the Court erroneously believed that at the time of the purchase at $1.15 per share the working capital of Masters was $3,247,790 (31A) when in fact it was in a deficit position by $66,000 (190A - the Court erroneously referred to Exhibit AH, page 3, which is totally unrelated); the Court also erroneously believed that the Masters net worth as of that same date was $2,718,000 (31A) when in fact it was in a deficit position (100A - Balance at beginning of period). Based on its erroneous belief that the working capital and net worth of Masters at the time that the Biblowitzes paid $1.15 per share (1963) was substantially greater than the working capital and net worth of Masters on July 30, 1966; viz. $1,857,000 (76A) and $1,677,000, respectively (75A), then the Court must have erroneously inferred that the price of $1.71 per Masters share fixed by Lou Biblowitz in 1966 was fair. However, since in

(footnote continued from preceding page)
Masters and its stockholders. Accordingly, reference to the testimony of Mr. Rosenthal to support the values is like citing the testimony of Lou Biblowitz, since Mr. Rosenthal at the time was a director of Masters and under Biblowitz influence.

fact that Masters working capital and net worth in 1963 at the time of the purchase of control were in a deficit, then we submit that the District Court was confused about the basic facts.

3. Valuation of Lady Rose. Lady Rose was a leased department operator. Plaintiffs' expert concluded that the value of Lady Rose was $3,350,000 plus $370,000 for the market value of its Masters' holdings in excess of cost for a total value of $3,720,000 (154A).

Plaintiffs' expert stated in support of his opinion (174A):

> "It was a buyer's market for leased department operators, and they sold in the market place for a very low valuation based on past growth trends. The highest valuation for these operators was when a landlord (such as Woolco with Kinney and K-Mart with Holly) wanted to expand rapidly and run its own departments but lacked the management expertise in certain areas.
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> * * *
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> "Lady Rose was protecting 3 of its leases in the Masters stores, and probably would take over other leases in those units as they expired. With the Masters' name and combined assets of the new company an expansion program was possible with the leverage inherent as an operator rather than lessee."

In fact, the Internal Revenue Service determined the important, genuine business reason for the merger (123A) to be that (125A): "The merger of Lady Rose into Masters will guarantee

the continuance of its businesses in the Masters stores." In valuing Lady Rose, Lou Biblowitz did not take into consideration the fact that Lady Rose concessions in Masters' metropolitan stores were due to expire on January 31, 1967 (L. Biblowitz TR 799). If the Lady Rose concessions in the Masters stores had been terminated by Masters' merging with a full line discount store or otherwise, Lady Rose's condition would have been materially adversely affected (Rosenthal, TR 1067-8, 1073-4).

Plaintiffs' expert expressed his opinion in light of the market prices for publicly traded leased department operators (157A), the fact that Lady Rose was a private, small company (TR 1210, 1156), and normally bigger companies sell at a higher valuation (Marx, TR 1208), the fact that Lady Rose was limited to one area, New York (TR 1210), and was not with any major chain (TR 1210).

Zayre had acquired Hardline Distributors, one of its leased department operators, at only 6.7 times earnings, even though the Hardline concessions in the Zayre stores expired more than 3 years later (159A-160A); Morse Shoe, a leased department oeprator, was selling at 8 times earnings with outstanding growth in revenues from $8.8 million to $91.7 million in a decade and a net earnings increase every year from $80,000 in 1957 to $5.3 million in 1966 (157A, Marx, TR 1164). Unishops operated 200 units, compared to 21 for Lady Rose; Unishops had much greater diversification

than Lady Rose; Unishops was in different parts of the country; Unishops sales were 68 million compared to 13 million for Lady Rose; there was greater predictability to Unishops' growth than to Lady Rose's because Unishops was growing with certain landlords (Marx, TR 1210); Unishops was selling at 8 times earnings (157A). Lady Rose had a reputation as a good operator, but it was not in any of the units operated by the major discount department store chains (Marx, TR 1205, 155A); Lady Rose in opening new units was not following the consistent pattern followed in a larger chain (Marx, TR 1210-12).

Defendants' expert did not cite any market data in his report (192A-198A) or direct testimony to support his choice of a multiple of 8 to 10 for Lady Rose. On cross-examination he conceded he used a composite index consisting of apparel and accessories stores not confined to leased department operators, taking an average of their December 1966 multiples (PX 156), to wit, 9.1, which was not representative of the market value of the leased department operators and was not an objective, scientific method (Whitman TR 1894-5, 1885-1895).

Lessors, recognizing the advantage of an integrated retailing operation, including the very important soft goods lines, consistently reexamine the cancellation of licensing agreements; Lady Rose concessions were always at risk; when as frequently occurs, lessors are merged, sold or otherwise

subjected to reorganization or changes, concessionaires such as Lady Rose are always seriously vulnerable to discontinuance; in view of the foregoing, it was essential for Lady Rose to seek a firmer integrated structure for its operations by broadening its operational base to approach the junior department store concept; it hoped to shift emphasis by the merger with Masters and thus expand along traditional department store lines rather than through the hazardous concession route (PX 25, pp. 18-9, L. Biblowitz TR 1411-5).

Over the years the discount stores with good management were gradually absorbing their leased departments either by acquisition or more often simply by not renewing the short-term leases and operating more departments themselves (Marx, TR 1213). The new retailing chains which were built rapidly with leased department locations saw the handwriting on the wall and were trying to acquire their own department stores in which they could operate and control the leases; examples were Unishops, Barbara Lynn and Spencer Shoe (Marx, TR 1215). These were among the reasons why these leased department firms' stocks sold at low multiples of earnings and book value, even where they exhibited above average growth (156A-157A, Marx, TR 1216).

Lady Rose did not have an active expansion program compared to other stores of similar size (Marx, TR 1295-7). It had the same number of units in operation in the beginning

of fiscal year 1967 as in the beginning of fiscal year 1965. (Marx TR 1295, p.42 of pre-trial order, ¶(c) 19) In fiscal 1967 Lady Rose closed five units, to wit, three in Miami, one in Newark, and one on 125th Street (161A, PX 133, p.7); for that year it opened four units, three of which required an immediate writedown in the value of the inventory purchased (L. Biblowitz, TR 1409).

Defendants' expert arbitrarily assumed that when Lady Rose's Florida units were sold, it would replace them with other, profitable units; one may not properly assume that every unit that Lady Rose opened was going to be as profitable as the discontinued Florida leased units (Whitman, TR 1878). (In fact, in three of the four stores opened in that same year, Lady Rose took a severe writedown of its purchased inventory (Whitman TR 1876-7) and lost money in them in the next fiscal year (DX D, p.11, last three columns)).

The main support advanced by defendants' expert for his assumption that there was an active expansion program at Lady Rose was the balance sheet item, at August 31, 1966, of $91,329.95 for advances for new operating units under construction; but he did not realize that five months later (January 28, 1967) the same amount continued on the books unchanged; no additional expenditures were capitalized in the interim and those units had not been completed (Whitman TR 1925-6).

An adjustment should be made in Lady Rose's reported numbers based on an event that transpired after the

close of fiscal 1966. In July 1966 Zayre purchased the three Miami stores of Masters and terminated Lady Rose's leased departments there. Lady Rose did not receive a premium over its book cost of inventory and fixtures on the sale to Zayre. Since Lady Rose was not shown to have then had an active expansion program, the volume from its discontinued Florida leases should be deleted in estimating Lady Rose's fiscal 1967 and future years'volume, profits and growth potential (160A-161A; Marx, TR 1227).

The unaudited six month operating results of Lady Rose ending August 31, 1966 were not entitled to much weight (Marx, TR 1234-5), since no physical inventory was taken. (J. Biblowitz, TR 453, 456) The unaudited results showed that the cost of goods sold dropped to 66%, while the prior audited three years showed approximately 69% (Marx, TR 1234-5). That was a significant decline in cost of sales and it required an explanation (Kopelson, TR 930-1) which was not forthcoming. For the months of December 1966 and January 1967 the net income of Lady Rose was $46,000; that was an unusually large drop for that time of the year; in purchasing Bargaintown's inventory in connection with opening three concessions in their stores, Lady Rose, around December 1, 1966, took big markdowns when that inventory did not come up to expectations (L. Biblowitz TR 1409). In fact, Lady Rose's actual earnings, without the discontinued Florida division, for fiscal 1967 (11 months)*

* Income for the month of February 1967 was not significant (148A, see double asterisk)

was $480,000. (40A,$527,000 less $47,000). Plaintiffs' expert used $480,000 as Lady Rose's net earnings from its continuing operations for the fiscal year 1967 (161A-162A, Marx, TR 1383-4).

At 7 times fiscal 1967's adjusted earnings of $480,000, as per plaintiffs' expert, the value of Lady Rose would be $3,360,000. Arguendo, even if we take 8 times, suggested as the bottom of the range by defendants' expert, the value of Lady Rose would be $3,840,000. If we employ the last full year's audited earnings, to wit, the fiscal year ending February 28, 1966, at the time Lady Rose was being valued in November, 1966, its value at 7 times adjusted earnings* would be $2,716,000 and at 8 times would be $3,104,000. A multiple of 7 is generous to Lady Rose in view of the small size of the company, its very limited marketability and the other pertinent factors already mentioned (162A, Marx, TR 1234). Therefore the range of value for Lady Rose is generous if we use fiscal 1967; namely, between $3,360,000 (plaintiffs' expert) and $3,840,000 (defendants' expert)**. That, indeed,

* Stipulated Fact, 144A, Lady Rose's net income for fiscal year ended February 28, 1966, less its discontinued Florida division's income is $388,000 ($452,000 less $64,000). Eliminating Lady Rose's discontinued Florida division yields net income for Lady Rose of $274,000 in fiscal 1965, $197,000 in fiscal 1964, $224,000 in fiscal 1963 (161A, 144A).

** Note, also, that $480,000 for fiscal 1967 includes $84,000 of net income from Masters' metropolitan stores (144A), which, if eliminated, since on a sale to a full line integrated operator it would be cancelled, reduces Lady Rose's value by a range of $588,000 (7x) to $692,000 (8x).

is more objective and well below the $6,000,000 set by Mr. Lou Biblowitz.

Argument

Point I

THE PROXY MISSTATEMENTS AND OMISSIONS WERE MATERIAL, IN VIOLATION OF SEC RULE 10b-5.

The proxy statement failed to disclose that the Biblowitz brothers were in control of both Masters and Lady Rose at and before the time of the merger; that Lou Biblowitz had fixed the terms of the merger for both Masters and (the Biblowitz family-owned) Lady Rose*; that Kalish Rubinroit, accountants for both Masters and Lady Rose, were secretly working to obtain the maximum advantage to the Biblowitzes in the merger at the expense of the Masters public stockholders; that Feldshuh & Frank as attorneys for both Masters and Lady Rose were under the influence of the Biblowitzes and in no position to protect the interests of Masters; that one of the directors of Masters voted against the merger on the ground that he disagreed with the values that were the basis for the merger; and that several of the directors of Masters had

* The District Court missed the thrust of plaintiffs' contention by holding (17A): "it would have to be assumed that [the Biblowitzes] set the terms for Lady Rose" but overlooked the failure to disclose the important fact that the Biblowitzes fixed the price of Masters (TR 1400, 782).

expressed the belief that the ratio of exchange was unduly advantageous to Lady Rose. The proxy statement stated that the terms of the merger were arrived at as a result of negotiation between the respective managements of Masters and Lady Rose - a plain misstatement since the terms for both companies were fixed by Lou Biblowitz. Lou Biblowitz stated to the stockholders that the "directors recommend your approval of the merger as being in the best interests of the stockholders of Masters Inc." and further that "Your directors believe that the terms of the merger are fair and equitable"; this was a misstatement in the light of the fact that one director voted against the merger because of the values fixed by the terms of the merger and several directors had stated that the terms of the merger were too high for Lady Rose and too low for Masters.

Furthermore, the proxy statement failed to disclose that Lou Biblowitz had decided to pay $777,000 for Masters and to take $6,000,000 for Lady Rose in the ratio of exchange. The proxy statement failed to show the operating loss from the discontinued Florida division of Masters separately from the operations of the metropolitan stores thereby conveying an entirely erroneous impression of the performance of the metropolitan stores, the only ones involved in the merger. The proxy statement failed to disclose separately the heavy proportion of Lady Rose's income* cut off by the

* 14% for fiscal 1966 (144A)

sale of the Florida stores and also failed to disclose the heavy proportion of Lady Rose's income* in the Masters metropolitan stores vulnerable to termination on short notice in the event of their sale.

The proxy statement, although giving the supposed opinion of the directors that the merger was "fair and equitable" to the Masters stockholders, failed to disclose and bring home to the stockholders the unique advantages to Lady Rose from the proposed merger; e.g. that one of the principal reasons why Lou Biblowitz wanted the merger was that "it will guarantee the continuance of [Lady Rose's] businesses in the Masters stores", free of vulnerability to termination and that Lou Biblowitz had assigned no value thereto in fixing the price of $777,000 that he was paying for Masters; that although Masters' tax loss carryforward of $3,378,849 was an important reason for Lou Biblowitz's deciding upon the merger and he set the terms of the merger in such a way as to maximize its utilization after the merger, that the accountants were of the opinion that, subject to a ruling by the IRS, "assuming that the pattern of performance of Lady Rose continued in the projected amount of $600,000 annual earnings, then the aforesaid carryforward loss would enable all earnings of the merged company to be after tax earnings, to the full extent of said loss." (51A-52A); yet he assigned nothing for it in the $777,000 that he fixed as the price for

* 17% for fiscal 1966 (144A)

Masters; that Lou Biblowitz hit on the $777,000 figure merely by arbitrarily deducting $900,000 from the Masters book value; and that he was taking $6,000,000 for Lady Rose predicated on a tenfold multiple of earnings which multiple he had not checked against any market data such as the earnings - multiple ratios of similar companies.

These omissions and misstatements went to the heart of the proposed merger and its terms. Clearly, they satisfy the test of materiality of this Court:

> "taking a properly realistic view, there is a substantial likelihood that the misstatement or omission may have led a stockholder to grant a proxy to the solicitor or to withhold one from the other side, whereas in the absence of this he would have taken a contrary course". Gerstle v. Gamble-Skogmo, Inc., 478 F2d 1281, 1302 (C.A.2, 1973)

Failure to disclose the Biblowitzes' control of both Masters and Lady Rose and Lou Biblowitz fixing the terms of the deal for both, and the misleading characterization thereof as the outcome of a "negotiation between the respective managements of Masters and Lady Rose" are by themselves materially misleading, in breach of Rule 10b-5, under Mills v. Electric Auto-Lite Co., 396 U.S. 375,378, 381.

The failure to disclose that Lou Biblowitz had decided to pay $777,000 for Masters and to get $6,000,000 for Lady Rose was a material omission within Gerstle v. Gamble-Skogmo, supra, at 1294 , where the Court distinguished

between a mere appraisal which ordinarily need not be disclosed and the firm offers of prices to be paid and received which should be disclosed.

Furthermore, the failure to separate out the losses from the discontinued Florida operations gave an entirely distorted view of Masters' metropolitan stores*, when in fact the operations of the metropolitan stores showed profits** and the basis for profitability. The failure to disclose to the stockholders the different profit-loss operations of the discontinued stores and the continuing metropolitan stores of Masters was clearly material under Gerstle v. Gamble-Skogmo, supra, at 1291, where the Court cited with approval the SEC position that

> "When a balance sheet in a proxy statement for a merger reflects assets at an amount that is substantially lower than their current liquidating value, and liquidation of those assets is intended or can reasonably be anticipated, the textual or narrative portion of the proxy statement must contain whatever available material information about their current liquidating value is necessary to make the proxy statement not misleading."

Our case is a fortiori because the Florida stores had already been liquidated at the time of the proxy statement. And the materiality of this omission was implicitly admitted by the defendants, for, in the post-merger Masters 1969 public offering prospectus, the operating losses from the discontinued

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* i.e. for the fiscal year ended April 30, 1966, $257,000 out of the loss of $260,000 was attributable to the discontinued Florida stores (143A).

** supra, p. 12.

Florida division of Masters were shown separately. The Court below also considered this omission as ordinarily material, stating as follows (20A-21A):

> "However, the court regards the closing of the apparently most unprofitable stores within a small chain to be a fact of enough importance that stockholders should be informed not only of the sale but also, to the extent possible, of the losses attributable to the discontinued operations. See Accounting Series Release No. 153, CCH FEDERAL SECURITIES LAW ¶72,071 ('...[D]isclosure should be as to significant, known factors that might render past earnings statements, or particular items therein, not indicative of probable future operations.')
>
> "While it might well have been impossible to pinpoint the extent of the losses attributable to the Florida operations during the six month period ending July 30, 1966, the stockholders should at least have been informed that a substantial proportion of the losses were attributable to discontinued operations."

The failure to disclose that Kalish Rubinroit, although accountants for Masters, were working to maximize the advantage of Lady Rose in the ratio of exchange and the inability of Feldshuh and Frank as attorneys to protect the interests of Masters because of their relationship to the Biblowitzes were also material under Kohn v. American Metal Climax, Inc., 458 F2d 255, 267, 268-9 (C.A.3).

Likewise, the failure to disclose the unique benefits Lady Rose was to obtain incident to the merger was material under Kohn, supra, at 265, where the Court held as follows:

> "The district court found that the benefits AMAX was to obtain as a result of the amalgamation were inadequately disclosed to the RST shareholders. In view of the close ties between AMAX and RST we agree that such disclosure would have been particularly important. The benefits accruing to AMAX included: (1) an increase of $7 million in annual income; (2) an improvement of $134 million in cash-flow during the period 1970 to 1975; (3) an improvement of $91 million in the corporation's balance of payments: and (4) the acquisition of high-yielding assets. We think the district court was justified in concluding that the piecemeal presentation of these benefits scattered throughout the proxy materials and the appendices was inadequate disclosure under the securities laws."

Our case is _a_ _fortiori_ where the unique benefits to Lady Rose referred to above were not at all disclosed in the proxy statement.

In _Republic Technology Fund_ v. _Lionel Corp._, 483 F2d 540 (C.A.2), this Court held that in a merger transaction the failure to disclose to stockholders a discrepancy in earnings that was at all substantial was a material omission in violation of Rule 10b-5. The failure to disclose that Lady Rose income, upon the basis of which Lou Biblowitz decided to take $6,000,000, included income in a separate specified amount from, respectively, the Florida operations, which had been discontinued, and from concessions in metropolitan stores, which were vulnerable to termination, was clearly a material omission within the principle of _Republic Technology_, _supra_. That Lady Rose might conceivably be able

to make up the income from other concessions yet to be located and obtained, on unknown terms, is beside the point, for it was fully up to the Masters stockholders to decide the seriousness of the loss to Lady Rose of the Florida income and of the vulnerability of the Lady Rose income from the metropolitan stores as against the conjectural chance that Lady Rose might make those up with other possible concessions, which of course might lose money as well as make it.

In Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F2d 341,364-5 (C.A.2), the Court pointed out that corporate insiders have a special responsibility to be meticulous and precise in their representations to shareholders; we submit that the proxy statement here falls far short of that requirement, even wholly apart from our contention that the proxy statement misrepresented the merger to be on "fair and equitable terms" when in fact those terms were unduly advantageous to the Biblowitzes who set the terms for themselves and the other party to the bargain.

With respect to the failure to disclose that Lou Biblowitz had decided to take $6,000,000 for Lady Rose, the Court below made no comment. With respect to the failure to disclose that he had decided to pay $777,000 for Masters, the Court below stated (22A-23A):

> "This was obviously important. However, there was nothing in the proxy statement which would have led the stockholders to believe that Masters I had been assigned a higher value ... the court has found that the terms of the merger, including the value assigned to Masters I, were indeed 'fair' to Masters' stockholders. Nor can the Court find that, given the poor condition of Masters I, the valuation given Masters was so low that reasonable stockholders might have considered the information as to the $770,000 valuation important in the making of their decision."

That begs the question. The Court is justifying the failure to give information on the ground that it concludes the transaction is fair. But the whole purpose in disclosing material information to the stockholders is so the stockholders will be in a position to make an intelligent determination of whether or not they believe the transaction to be fair after considering all the facts. Certainly before any stockholder can make a determination of whether a transaction is fair, he must know the respective purchase and sale prices that have been fixed.

The stockholders here could conclude from the number of shares given to Lady Rose, to wit, equivalent to 3,500,000 shares, and from the number of shares that would remain in the hands of the Masters stockholders, to wit, 391,100*, that Lady Rose was being priced at a ratio of approximately nine times the price of Masters. Did this mean that Masters was

* After Lady Rose's holdings in Masters became treasury shares of Masters on the merger becoming effective. (87A)

being bought for $1,000,00 and Lady Rose for $9,000,000, or Masters for $2,000,000 and Lady Rose for $18,000,000, or Masters for $3,000,000 and Lady Rose for $27,000,000 ? Indeed, there is a substantial difference. If stockholders do not know the prices fixed for each component company in a merger, they cannot make an intelligent decision as to whether the terms of the transaction are fair.

The District Court's substitution of its judgment for the judgment of the stockholders runs afoul of Mills, supra, at 381 where the Supreme Court, reversing the decision of the Seventh Circuit, stated:

> "The decision below, by permitting all liability to be foreclosed on the basis of a finding that the merger was fair, would allow the stockholders to be bypassed, at least where the only legal challenge to the merger is a suit for retrospective relief after the meeting has been held. A judicial appraisal of the merger's merits could be substituted for the actual and informed vote of the stockholders."

The District Court stated that the stockholders would not have attached importance to the omissions and misstatements because of "the poor financial condition of Masters" (15A). In the first place, this flies in the face of Mills, supra, that failure to disclose control and sitting on both sides of the bargaining table is materially misleading, even if the terms of the deal are fair; this goes, also, for the failure to disclose the partisanship of Kalish, Rubinroit and the inability of Feldshuh and Frank to protect Masters'

interest; and the failure to disclose the dissent of a director and the affirmative misleading implication that the vote was unanimous. Secondly, the District Court's view flies in the fact of the holding in Mills, supra, that under Rule 10b-5 the decision as to fairness is to be made by the stockholders who should not be by-passed by the court. See, also, Sonesta Intl. Hotels Corp. v. Wellington Associates, 483 F2d 247 (C.A.2) which held that even a generous offer would not excuse failure to disclose material facts. In the third place, "poor financial condition" is not a specific thing - there is a substantial likelihood that the stockholders' view of Masters' and Lady Rose's respective worths would be influenced by information that a director had voted against the merger because of the ratio of exchange; that other directors believed that the exchange should be share for share, not 9 shares to the Biblowitzes for each share to the public; that the price for Masters was arbitrarily set by Lou Biblowitz at less than half of book value with nothing for a $3,378,849 tax loss carryforward where the merger was set up to fully utilize it and nothing for Lady Rose's shedding vulnerable concession status via the merger although that was a principal reason for the merger; and that the price for Lady Rose was fixed by Lou Biblowitz at $6,000,000 based partly on income that had lapsed (Florida stores discontinued), partly on income that was vulnerable to lapse (concessions in Masters' metropolitan stores), and on a multiple that Lou Biblowitz

had set without reference to any comparable market data. Finally, the supposed "poor financial condition" was, as shown above (pp.10-15)ficitional; there is, in any event, clearly a substantial likelihood that the stockholders would have appraised the situation more favorably than they had an opportunity to do, if they had been told that the Masters losses shown were in fact due to the Florida operations that had been discontinued by the time of the merger and that the metropolitan stores had had profits.

Plainly, the material misstatements and omissions made here are sufficient to satisfy the reliance and causation, scienter and culpability requirements of Rule 10b-5. See e.g. Mills, supra; Affiliated Ute Citizens v. United States, 406 U.S. 128, 154; SEC v. Texas Gulf Sulphur, 401 F2d 833 (C.A.2); Gerstle v. Gamble-Skogmo, Inc., supra,1298 et seq.; Chris-Craft Industries, Inc. v. Piper Aircraft Corp., supra; Shapiro v. Merrill Lynch, F2d (C.A.2, April 3, 1974).

Point II

THE BIBLOWITZES, AS FIDUCIARIES OF MASTERS, FAILED TO SUSTAIN THEIR "BURDEN" OF PROVING THE "INHERENT FAIRNESS" OF THE TRANSACTION "FROM THE VIEWPOINT OF THE CORPORATION AND THOSE INTERESTED THEREIN" [PEPPER v. LITTON, 308 U.S. 295, 306].

The Biblowitzes were directors of Masters, its dominant stockholders, and concededly in control of both Masters and their family-owned Lady Rose (139A). Accordingly,

as defendants conceded at trial, the Biblowitzes had the duties of fiduciaries vis-a-vis Masters in the merger of Lady Rose into Masters. Pepper v. Litton, 308 U.S. 295, 306-7 sets forth the applicable "cardinal principles of equity jurisprudence" as follows:

> "A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside." [footnote and citations omitted]

That, of course, is, also, a correct statement of New York law. Pearlman v. Feldman, 219 F2d 173, 176 (C.A.2). Thus, e.g. in Globe Woolen Co. v. Utica Gas & Electric Co., 224 N.Y. 483, 490, the New York Court of Appeals, per Cardozo, J., held as follows as to a contract set by a corporate fiduciary sitting on both sides of the bargaining table:

> "There was, then, a relation of trust reposed, of influence exerted, of superior knowledge on the one side, and legitimate dependence on the other (Sage v. Culver, 147 N.Y.241, 247 ...) ... A trustee may not cling to contracts thus won unless their terms are fair and just ... His dealings with his beneficiary are 'viewed with jealousy

"by the courts, and may be set aside on slight grounds' (Twin Lick Oil Co. v. Marbury, 91 U.S. 587, 588). He takes the risk of an enforced surrender of his bargain if it turns out to be improvident. There must be candor and equity in the transaction, and some reasonable proportion between benefits and burdens."

And in Ripley v. I.R.C.A., 8 N.Y.2d 430, the controlling corporation was required by equity to reform an objectively unfair contract and to pay fair rates for its shipments over the controlled railroad (at 447).

We submit that the Biblowitz brothers have clearly failed to sustain their burden and that the terms of the merger imposed on Masters by Lou Biblowitz were "inherently" unfair to Masters and its public stockholders; that they do not carry "the earmarks of an arm's length bargain"; that they do not embody a "reasonable proportion" of the benefits between the public - getting 10% - and the Biblowitzes - getting 90%; and that they are objectively unfair, wholly apart from whether the Biblowitzes acted in bad faith.

A. The Biblowitzes Paid Nothing For Acquiring Masters' Corporate Advantage - The Right To Use The Tax Loss - Worth At Least $800,000.

Lou Biblowitz wanted the merger, among other reasons, because of Masters' tax loss carry-overs of $3,378,849 (74A-75A); he and his advisers set up the merger plan in such a way as to fully utilize such tax loss (74A-75A, 134A); the proxy

statement stated that tax benefits were expected to result from the merger (88A ¶2); that confidence was reinforced when - before the consummation of the merger - they received a favorable opinion from special tax counsel (88A-89A) and a favorable ruling from the IRS (135A). Plaintiffs' expert testified that, applying recognized techniques, the more than 3 1/3 million tax loss was worth at least $800,000 at the time of the merger (173A). That opinion was confirmed by the fact that the tax loss was actually fully utilized for a cash benefit of $1,905,000 (70A). The benefit therefrom to the 90% Biblowitz interest was $1,700,000; for this Lou Biblowitz decreed that they pay nothing, and they did pay nothing to Masters or the public stockholders.

That was a gross and patent misappropriation by a fiduciary of a corporate advantage belonging to Masters. Pearlman v. Feldman, 219 F2d 173 (C.A.2). In that case, this Court, reversing the District Court, held as follows:

> "... the responsibility of the fiduciary is not limited to a proper regard for the tangible balance sheet assets of the corporation, but includes the dedication of his uncorrupted business judgment for the sole benefit of the corporation, in any dealings which may adversely affect it. ... (176)
>
> "... The actions of defendants in siphoning off for personal gain corporate advantages to be derived from a favorable market situation do not betoken the necessary undivided loyalty owed by the fiduciary to his principal. (176)
>
> "The corporate opportunities of whose misappropriation the minority stockholders complain need not have been an absolute certainty in order to support this action against Feldman. If there

> "was a possibility of corporate gain, they are entitled to recover. ... (176-7)
>
> "... Only if defendants had been able to negate completely any possibility of gain by Newport could they have prevailed." (177)

It is shocking and stultifying for defendants to contend a corporate advantage had no value, when they had their tongues hanging out for it, carefully laid the necessary ground work to get it, got the right tax opinion and IRS ruling, said at the time they expected benefits to result from it, and in fact realized from it cash benefits of $1,905,000. Their conduct clearly comes within the condemnation of Pearlman, supra.

As Mr. Justice Jackson observed, it is

> "The right to use the [tax] loss as an offset that is valuable." *

Indeed, as he noted, "it is probable that the intention of the statute ... was to provide salvage for the loser." It obviously belonged to Masters and it had "value to one in a

* Western Pac. R. Corp. v. Western Pac. R. Co., 345 U.S. 247, 273, 276-7. The Supreme Court remanded on a procedural point, not reaching the merits. Mr. Justice Jackson, dissenting from this disposition, considered the merits. On remand, the Court of Appeals held that there the corporation giving up the benefit of a tax loss in a consolidated return was in control; the subsidiary getting the advantage thus had no fiduciary obligation to breach. 206 F2d 495, 497 et seq. (C.A.9). But where an advantage is taken by the fiduciary from the cestui without compensation, that is the fruit of a breach of fiduciary obligation. Pearlman, supra. It is settled law that such fruits belong to the cestui, not to the fiduciary. Meinhard v. Salmon, 249 N.Y. 458; Sautter v. Fulmer, 258 N.Y. 107; Jackson v. Smith, 254 U.S. 586.

position to utilize it." Why should the Biblowitzes, Masters' fiduciaries, be allowed to appropriate it gratis? Mr. Justice Jackson stated: "I know of no moral or legal obligation to give away any legal opportunity or advantage just because its owner cannot utilize it himself." As Lady Rose, the fiduciary, wanted to acquire it through merger, it had to pay for it. As Pearlman, supra, held, "If there was a possibility of corporate gain, they [plaintiffs] are entitled to recover." True, Lady Rose's profits were necessary, too, if the surviving corporation was to benefit from the tax loss but those profits were already given value once in applying a multiple and further as Mr. Justice Jackson pointed out, that was to be taken into the account in making a fair bargain,not in a fiduciary's taking it all for nothing. Moreover, though this is by no means necessary to plaintiffs' case, there was no absolute certainty that Masters could not have merged with another company that was prepared to act more equitably*. But that in itself is enough to show a breach of fiduciary obligation under Pearlman, supra: "Only if defendants had been able to negate completely any possibility of gain by Newport could they have prevailed."

Plaintiffs' expert's appraisal of $800,000 as the worth of the tax loss at the time of the merger was corroborated

* The only companies approached were those in whose stores Lady Rose had concessions (TR 917-9, 783-6, 309).

by the actualities: the full utilization thereof with cash benefits realized therefrom of $1,905,000. U.S. v. Brooklyn Union Gas Co., 168 F2d 391 (C.A. 2). There this Court, in reversing the District Court in a condemnation case for refusing to consider the subsequent actualities as a support of or check on an appraisal, held as follows (397):

> "The question then becomes one whether deductions as to the future may be checked up by the actualities as they have happened. It would seem an eerie conclusion that a court must resort to guess, closing its eyes to reality, when its decision must actually be formulated after the true facts have become available. We think the evidence admissible not as a standard of value in itself, but for its bearing upon the prospective values at the time of taking. After all, the nature of the improvement was not shrouded in mystery. There were clear grounds for expecting some development of the kind that actually happened, and evidence of such actual happening is useful to support or check the assumed prospects."

B. Lou Biblowitz Paid $777,000 For Masters' Assets Worth $2,550,000.

An early plan that Lou Biblowitz's advisers came up with gave the Biblowitz interest 80% and the public interest 20% in the surviving corporation (209A-212A). Without any indication that the public stockholder interest was worth less than when the final plan was drawn, Lou Biblowitz increased

his family's interest to 90% and decreased the public stockholder interest - by half - to 10%. All that Lou Biblowitz did in deciding to pay $777,000 for Masters was arbitrarily to discount the Masters' book value of $1,677,000 by more than half.

The undisputed evidence shows that companies comparable to Masters* were, although losing money, uniformly selling, at the time, for book value or more when they were acquired (166A-172A). Lady Rose as a concessionaire in Masters stores was vulnerable to terminations and that was a prime reason why Lou Biblowitz decided on the merger. That was, therefore, an important corporate advantage belonging to Masters; yet it was appropriated by the fiduciary with nothing paid for it, in flagrant contravention of the rule of Pearlman v. Feldman, supra. Not only did Lady Rose appropriate it without payment, but it charged Masters $1,400,000 (TR 800-2; 804-5, 807) for Masters' right to terminate those concessions** by applying a multiple of 10 to Lady Rose's earnings in those Masters stores, even though some were already discontinued.

* "In valuing the whole enterprise, he must seek out financial data on comparable companies in order to determine definitive ratios that can be used to give an indication of the value of the company he is analyzing." "Valuation factors and techniques in mergers and acquisitions" by John Heath, Jr., Vice President, Marshall & Stevens Incorporated. 40 The Financial Executive (Ap. 1972) 34, 40

** Masters' right to terminate was almost at will since the Lady Rose concessions in the Masters stores expired on January 31, 1967 and Masters had the right to terminate those Lady Rose concessions on short notice on a bona fide sale of its assets.

Thus, any purchaser of Masters, having its own softlines, in an arm's length bargain would acquire Masters and cancel the profitable Lady Rose and Rockower concessions and operate them itself (TR 383-4, 390-1). After the merger, Masters did just that; it took over the operation of Rockower's concessions (TR 1427). Therefore, a purchaser of Masters would pay Masters for the right to operate those profitable concessions; the asset belonged to Masters and not to Lady Rose.* What a glaring disproportion imposed by Lou Biblowitz on his cestui: valuing Lady Rose's vulnerable concessions in Masters' stores at $1,400,000 but valuing all of Masters, including its potential tax loss offset of over 3 million dollars and the right to cancel those concessions, at $777,000, less than half of Masters' book value!

No value was attached to Masters' large annual volume, $18,000,000 (60A)**, also a concededly important corporate advantage (174A-175A, TR 1823). This, too, was appropriated by the fiduciary without compensation to the cestui.

Plainly, this transaction between fiduciary and cestui did not bear the earmarks of an arm's length bargain and was inherently unfair to Masters and its stockholders in breach of the cardinal principles of equity as laid down by Pepper v. Litton and Globe Woolen, supra.***

* Lady Rose would only be in a position to retain or sell its inventory and fixtures.

** Lady Rose's was $13,000,000 (61A).

*** In Lebold v. Inland Steel Co., 125 F2d 369 (C.A.7, 1941) the Court held: as "majority stockholder", the steel company was "trustee" with the obligation to do "what is best for the [shipping] corporation ... [its] own selfish interests must be ignored." (372-373).

Considering the Masters book value and these corporate advantages belonging to Masters including $800,000 for the tax loss, in the light of the comparable, contemporaneous data, a reasonable value for Masters at the time of the merger, as estimated by plaintiffs' expert (154A), is $3,000,000 - or, after deducting Lady Rose's stock interest in Masters, $2,550,000 for the public stockholder interest. This value finds support in defendant counsel's concession (TR 1803-4) that the post-merger corporation was operating a successful and profitable business.

C. Lou Biblowitz Set The Sales Price At 6 Million Dollars For The Biblowitz Assets (Lady Rose), Worth Only $3,720,000.

Lou Biblowitz fixed the merger sales price for Lady Rose, his family-owned leased department operation, at 6 million dollars. His formula was: 10 times projected annual earnings of $600,000. He had no comparable market data, and none was produced at the trial, to support the multiple of 10.

Plaintiffs' expert testified to a multiple of 7 as the appropriate one at the time of the merger, basing his opinion primarily on the contemporaneous market prices for publicly traded leased department operators (155A-161A). Lady Rose, a private, small company, limited to one area, and

not with any major chain would not have as high a multiple as the large,profitable publicly traded companies (162A). At a multiple of 7, Lady Rose was worth $1,800,000 less than the price Lou Biblowitz put on it even, arguendo, using the Biblowitz estimated earnings of $600,000. Taking even defendants' trial expert's multiple of 8 would knock $1,200,000 off the Biblowitz sales price for Lady Rose - that expert proposed a range of multiples from 8 to 10 without support from the comparable market data for leased department operators; he used an index including higher valued and non-comparable apparel and accessories stores (PX 156).

Lou Biblowitz's projection of annual $600,000 earnings for Lady Rose was also very infirm (pp. 44-5 above); e.g., it included the income of $47,000 from the discontinued Florida operation and $84,000 from the vulnerable concessions (40A) in the Masters' metropolitan stores, due to expire January 31, 1967 (92A), without any showing of what substitute concessions would make up such income. It relied on 6 month unaudited operating results which were practically worthless as no physical inventory was taken and that statement was issued on November 4, 1966 (PX 136) after the Biblowitzes and Kalish, Rubinroit submitted the plan of merger to the Masters Board on October 31, 1966 with their objective of maximizing the interests of the Biblowitzes in the surviving company.

Considering that the burden is on the Biblowitzes to prove fairness affirmatively, the only reliable figure for

Lady Rose income as a valuation base, would be its actual 1967 fiscal*, excluding the discontinued Florida division. That figure is $480,000 (above p. 45). Multiplying it by 7 equals $3,360,000. Plaintiff's expert rounded this off to $3,350,000 and added another $370,000 in recognition of the extra value over cost for the Lady Rose interest in Masters (see p. 39 , above). In short, Lady Rose was worth $3,720,000, less than 2/3rds of the 6 million dollars Lou Biblowitz set in selling his (family) business to his cestui.

D. The Fair Ratio of Exchange.

Lou Biblowitz, the fiduciary, fixed as the ratio of exchange in the merger 90% for himself and his family and 10% for his beneficiaries, the public stockholders. Revision to a ratio of 62% for the Biblowitzes and 38% for the public is required to make the transaction inherently fair to Masters and its public stockholders (154A)**.

CONCLUSION

This is a case of flagrant misleading of his cestuis by a self-dealing fiduciary, in violation of 10b-5. The fiduciary has also failed to sustain his burden of proving, objectively, that the deal was fair to the beneficiaries;

* Ending January 28, 1967, the last year of Lady Rose's operation.

** This takes account of (a) Masters' tax loss worth $800,000 and Masters' fair worth inclusive thereof of $3,000,000, (b) Lady Rose's fair worth of $3,350,000, and (c) the adjustment required by Lady Rose's stock interest in Masters (154A).

there was a disproportion in the ratio of exchange fixed by the fiduciary that constituted a shocking breach of fiduciary obligation.

The decision below for the individual defendants commits error of law and clear error of fact, representing a sharp departure from the high standards required of fiduciaries in enforcement of fiduciary obligations and the securities laws. The judgment therefore should be reversed.

It is, of course, too late to unscramble the merger effected in 1967; so the District Court should be instructed to formulate an appropriate remedy of restitution, based on the fair 38-62 ratio of exchange; namely $3,720,000 for the Biblowitz interest and $2,550,000 for Masters (after adjustment for the Lady Rose stock interest in Masters). Counsel believes that Norte & Co. v. Huffines, 416 F2d 1187 (C.A.2) mandates that the relief be all to Masters, Inc., i.e. a derivative action basis; but as a matter of fairness to the plaintiff stockholders, it may be considered in part a class action as well.

Accordingly, the judgment should be reversed, with directions as requested.

Dated: May 22, 1974

Respectfully,

LEVENTRITT LEWITTES & BENDER

By Sidney Bender
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